

## **CHAPTER IV**

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### **ALTERNATIVE ORGANIZATIONAL FORMS**

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If policymakers decided to create the National Infrastructure Corporation and the Infrastructure Insurance Company that the commission proposed, the corporations could be organized in one of several ways. Both could be established as on-budget agencies. Alternatively, the corporations could be organized as private, for-profit firms. The NIC could be established as a government-sponsored enterprise or as a special-purpose finance company that received a long-term federal loan at a below-market interest rate. The IIC could be established as a municipal bond insurer with the government initially as a minority owner, as the commission proposed. Each organizational form would affect the information available about the corporations, the degree of control that policymakers had over the subsidies that they conveyed to infrastructure borrowers, and their competitive advantages over private firms that could provide the same financial services. The analysis of those alternatives in this chapter is independent of the discussion in Chapter III of how the activities of the NIC and the IIC would affect the allocation of resources.

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### **ESTABLISHING THE CORPORATIONS AS ON-BUDGET AGENCIES**

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If the corporations were established as on-budget agencies, the NIC's purchases of subordinated infrastructure bonds would be federal direct loans, and the IIC's insurance of senior debt would convey an explicit federal guarantee. The Federal Credit Reform Act of 1990 reformed the budgetary treatment and control of federal loans and loan guarantees. Under the act, neither the NIC nor the IIC could commit itself to provide credit assistance to infrastructure borrowers without first receiving appropriations to pay the estimated subsidy cost of the assistance. Annual appropriations would also be required to finance the NIC's development risk insurance and each corporation's administrative expenses. Most of the implications of organizing the NIC and the IIC as on-budget agencies would reflect features of credit reform.<sup>1</sup>

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1. For more detail on the budgetary treatment and control of federal direct loans and loan guarantees under credit reform, see Congressional Budget Office, "An Explanation of the Budgetary Changes Under Credit Reform," CBO Staff Memorandum (April 1991).

### Paying the Cost of Subsidies Through the Appropriation Process

If the NIC and the IIC were organized as on-budget agencies, the federal budget would measure the cost to the government of their activities, and policymakers would exert direct control over those costs, through the appropriation process. Policymakers would have to appropriate funds equal to the estimated subsidy cost of the NIC's purchases of infrastructure bonds, and of any subsidized bond insurance provided by the IIC, before the corporations could commit to provide the credit assistance. The NIC's development risk insurance and the administrative expenses of each corporation would require separate appropriations.<sup>2</sup> All appropriations to the two corporations would be on-budget.

Under credit reform, the subsidy cost of a federal loan or loan guarantee is defined as the loss that the government expects to incur on the transaction. That loss is measured narrowly as the difference between the government's cash flows in the year in which the transaction occurs and the net present value of all future cash flows resulting from the transaction. For example, if the NIC as an on-budget agency purchased \$100 million in subordinated bonds and expected to receive interest and principal payments with a net present value of \$95 million, the subsidy cost of the loans would be \$5 million. Similarly, if the IIC insured \$100 million in debt that had been issued to finance various infrastructure projects and received insurance premiums totaling \$5 million, but expected to incur default losses with a net present value of \$8 million, the subsidy cost of the insurance would be \$3 million.

### Limitations of the Subsidy Cost Measure

If the NIC and the IIC were organized as on-budget agencies and policymakers authorized the corporations to compete with the private bond insurance industry or other firms or investors that bear the credit risk of infrastructure bonds, the agencies would have a competitive advantage. That advantage would arise from the way in which the subsidy cost of federal credit assistance is estimated, which understates the government's cost.

Under credit reform, the subsidy cost is defined to exclude the costs of forgoing a market rate of return on capital and of administering federal credit programs. The government calculates the net present value of a federal agency's expected future cash flows resulting from credit assistance over a year by using a discount rate equal to the projected interest rate on Treasury debt of the same

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2. The NIC's development risk insurance would not be considered a federal credit program because the corporation would not insure the debt of infrastructure project developers. It would protect them against losing the money they put up to cover development costs.

maturity as the average assisted loan issued by the agency in that year. The calculation excludes the costs of administering the credit assistance because the costs of administering all of an agency's programs are financed together in many cases and loan administration costs are hard to break out.<sup>3</sup> These practices have the effect of reducing estimates of subsidy costs, relative to estimates based on discount rates that include premiums to pay the cost of bearing the uncertainty about expected default losses, administrative expenses, and a markup for profit.<sup>4</sup>

Under the estimating rules established by credit reform, credit programs do not require subsidy cost appropriations if the programs charge interest rates, guarantee fees, or insurance premiums that are high enough to cover their default losses and the interest on Treasury debt issued to finance them. That principle applies even though the programs are subsidized; that is, the government is administering them free of charge (for the purpose of credit reform) and accepting a below-market rate of return on them. Credit programs do not need to charge prices that earn a market rate of return because the government does not compensate taxpayers for the alternative use of their tax dollars. On-budget credit programs also have the advantage of being able to raise funds in the very large, liquid market for Treasury securities. For these reasons, if the NIC and the IIC were on-budget agencies, they would have a competitive advantage over any private firms and investors that provided the same financial services without federal subsidies. They could use that advantage to monopolize the markets they served.

An approach is available to limit the ability of the NIC and the IIC to use their competitive advantage to take profitable business away from the private sector. Specifically, policymakers could restrict their activities to bearing the credit risk on infrastructure debt that had been turned down by the municipal credit market or the municipal bond insurance industry. But a turn-down requirement would not prevent the NIC from financing some projects that the private sector could finance on its own. For example, private bond insurers might be willing to insure asset-backed securities collateralized by a pool of infrastructure bonds that they would turn down singly. Insurance might be

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3. Although the costs of administering credit programs are financed through the appropriation process and included in agency budgets, Congressional decisions about those costs are separate from those made about the subsidies conveyed to borrowers through federal direct loans and loan guarantees.

4. In an earlier study, CBO found that excluding administrative expenses reduced the estimated subsidy cost of federal credit programs in fiscal year 1991 by between 10 percent and 85 percent; the specific percentage varied with the characteristics of the program. See Congressional Budget Office, *Budgeting for Administrative Costs Under Credit Reform* (January 1992), pp. 20-21, Table 9. Some analysts defend the practice of ignoring the cost of bearing uncertainty about expected losses on the grounds that the government's large portfolio of loans and guarantees enables it to reduce that cost through diversification.

available if the pool was large and diverse and if each issuer had pledged some of its debt proceeds to cover delinquency or default by other issuers.

#### Direct Provision of Federal Assistance to Infrastructure Borrowers

If the NIC and the IIC were on-budget agencies, the government would provide credit assistance directly to infrastructure borrowers, rather than indirectly through private financial institutions. One implication of assisting borrowers directly would be that the corporations could buy or insure bonds that had been issued to finance very risky infrastructure projects. In contrast, as a GSE or a private finance company, the NIC would have an incentive to allocate its capital to activities that promised to earn the highest risk-adjusted rates of return and, under most conditions, to avoid financing high-risk projects. For similar reasons, as a private, for-profit insurer, the IIC might avoid insuring infrastructure bonds that were not eligible for an investment-grade credit rating.

Assisting infrastructure borrowers directly would also ensure that they were the recipients of federal subsidies. If the NIC was organized as a GSE, infrastructure borrowers might not receive all of the federal subsidies conveyed by the implicit guarantee of the corporation's obligations because its owners and management would be able to retain some of the subsidies. Furthermore, investors in tax-advantaged municipal bonds inevitably receive some of the subsidies intended for issuers of the debt. An investor's gain from exempting the interest on municipal debt from federal taxes is the excess of the loss to the government over and above the reduction in the issuer's borrowing costs. This windfall to bondholders has been estimated to be about 23 percent of the federal subsidy (about \$6 billion in 1992).<sup>5</sup> The windfall arises because all investors in tax-exempt bonds with a marginal tax rate greater than the break-even tax rate (the rate at which the after-tax returns on taxable and tax-exempt bonds are equal) save more in federal income taxes than the issuers save in interest costs.

#### Comparison with Establishing the NIC as an Off-Budget Corporation

The commission appeared to propose that, during the first phase of the NIC's existence, it would be an off-budget, federally chartered corporation that would operate solely with federal funds and have no authority to borrow from the Treasury or the public. Placing the NIC, and the IIC as its subsidiary, outside the federal budget would conflict with the fundamental, long-standing norm of

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5. Peter Fortune, "The Municipal Bond Market. Part II: Problems and Politics," *New England Economic Review* (May/June 1992), p. 52.

including in the budget the transactions of all federal agencies and all nominally private firms that are controlled and owned by the government. That norm facilitates comparison and control of the costs of, and accurate measurement of the share of national output absorbed by, all activities that involve the exercise of the sovereign power. In addition, as an off-budget entity, the NIC would require much larger initial federal appropriations than it would as an on-budget agency, although being off-budget would allow it to operate as a revolving fund. Whether the NIC was on- or off-budget, policymakers could give it the same discretion to select the infrastructure projects that it would support and to determine the amount of the subsidies that it would provide to each project.

Larger Initial Appropriations Required to Finance an Off-Budget Corporation. The NIC would require much larger appropriations to finance its initial purchases of subordinated infrastructure bonds as an off-budget corporation than it would as an on-budget federal agency. In its report, the commission assumed that the NIC would receive \$3.25 billion from the government to finance the purchase of an equal amount of bonds. It also assumed that the bonds would mature in 20 years and that half of the debt would pay a taxable and half a tax-exempt interest rate; the average interest rate on the debt would be 7.5 percent. If the bonds were eligible for a credit rating of double B, as suggested in Chapter I, the purchases would have an average subsidy cost of about 33 percent. Therefore, to finance the purchases as an on-budget agency, the corporation would need a subsidy cost appropriation of only about \$1.1 billion.

Off-Budget Corporation Could Operate as a Revolving Fund. If the Congress organized the NIC as an on-budget agency, credit reform would prevent the corporation from "recycling" payments by borrowers and making new loans without prior Congressional action (as it could have done before credit reform). As a result, when issuers of subordinated infrastructure debt purchased by the corporation made payments of principal and interest, the funds would not be available to finance new credit assistance. Instead, the estimated subsidy cost of the new loans would be charged against the appropriation provided for that year and for that purpose. The Congress also would not appropriate funds to capitalize the NIC. Instead, it would finance the subsidy cost of the corporation's loans and loan guarantees, the cost of its development risk insurance, and its administrative expenses with annual appropriations rather than with a revolving fund's capital and payments from borrowers.

The commission's report explicitly advocated allowing the NIC to operate as a revolving fund. The commission appeared to take the view that the credit reform requirement that the Congress appropriate funds to cover the subsidy cost of new NIC credit assistance would be a disadvantage, because fluctuations in that annual funding could curtail the corporation's support of

municipal infrastructure borrowing. The Credit Reform Act represents a decisive rejection of that perspective, however. The law reflects a judgment by policymakers that more accurate, timely information about the cost of federal credit assistance and annual Congressional control of that cost are more important than agency discretion over the terms on which credit assistance is provided or the volume of federally assisted loans.

Discretion to Select Projects. The Congress could give the NIC as an on-budget agency the same degree of discretion over the types of infrastructure projects that it financed as it would have as an off-budget revolving fund. Policymakers could direct the corporation to select projects on a nationwide rather than a state-by-state basis, target projects with regional or multistate significance, choose projects financed with user charges, or limit the subsidies it provided to a small portion of project costs, to cite several of the commission's objectives.

#### Authorizing the IIC to Provide Direct Loans Rather Than Insurance

One implication of establishing the IIC as an on-budget agency is that current federal law would deny tax-exempt status to any municipal debt that the company had insured. An alternative would be to allow the IIC to purchase, rather than insure, infrastructure debt that paid the same interest rates that the jurisdictions would have to pay to sell tax-exempt debt that carried bond insurance. Assuming that the IIC charged fees that covered the cost of expected defaults, the subsidy cost of the loans, which would have to be appropriated each year, would equal the present value of the difference between the rates on Treasury securities and on triple-A-rated, tax-exempt bonds.

#### ESTABLISHING THE NIC AS A GOVERNMENT-SPONSORED ENTERPRISE

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The commission was aware of the option of establishing the NIC as a government-sponsored enterprise. Chapter I noted that as a GSE, the corporation would benefit from an implicit federal guarantee of its obligations. That guarantee, as well as the tax subsidies that would be provided to qualified pension plans that invested in the NIC's obligations if they were defined as eligible infrastructure securities, would lower the corporation's borrowing costs. The NIC could pass the savings through to municipalities by charging them below-market interest rates on their infrastructure debt. The implications of organizing the NIC as a GSE would be consequences of the implicit federal guarantee and the corporation's private ownership.

### Ability to Subsidize an Indefinite Volume of Borrowing

As a GSE, the NIC could subsidize an indefinite amount of infrastructure borrowing, provided that it was profitable enough to attract private capital. But the corporation could not finance taxable infrastructure debt at interest rates that were close to those on tax-exempt bonds unless policymakers approved the commission's proposal to provide a new tax subsidy to qualified pension plans that invested in its debt securities. If the new tax subsidy was not available, the volume of infrastructure debt that the NIC could finance would be quite limited.

### Exclusion from the Federal Budget

If the NIC was organized as a GSE, the federal budget would record no cost to the government associated with the implicit federal guarantee of the corporation's obligations. Of course, if the NIC ever suffered large losses and the Congress provided financial assistance to it in order to sustain its operations and protect the huge market in GSE obligations, appropriations to pay for the assistance would increase the budget deficit at that time unless offsetting cuts in other spending were made. Policymakers, however, would have no direct way to control the cost of the implicit federal guarantee of the corporation's obligations through the annual budget and appropriation process. Instead, the President and the Congress would have to use indirect means to control that cost, as explained below.

### Incentive to Increase Risk

If the NIC was a government-sponsored enterprise, the implicit federal guarantee of its obligations would give it an incentive to increase its risk, especially if its current net worth were negative and it did not expect to be profitable in the future. The corporation would have this incentive because its owners would benefit most from any gains that resulted from greater risk, whereas the government would absorb most of any losses.

One way that the NIC could increase its risk would be to reduce the amount of capital it maintained relative to a given volume of infrastructure bonds that it had purchased or guaranteed. The corporation could also take more credit risk or interest rate risk (the risk of losses from changes in interest rates) and charge higher interest rates or guarantee fees to compensate for the greater possibility of loss. In the short run, lower capital or higher interest or fee income would raise the NIC's rate of return on equity and, absent federal restrictions, increase the dividends per share that it could pay to stockholders.

In the long run, however, such actions would also increase the corporation's risk of becoming insolvent and needing federal financial assistance.

The NIC would be most likely to take greater risks if it became insolvent and was allowed to remain in business.<sup>6</sup> At that point, the corporation would have an incentive to purchase or guarantee infrastructure debt on which, on average, it expected to lose money, provided that it also earned high interest rates and guarantee fees on that debt and some of the bonds were likely to be repaid in full some of the time. Because the firm's owners would no longer have any of their own money at stake, they would have everything to gain from the profits that greater risk-taking might earn, even if success was unlikely, and they would have nothing to lose from the losses, even if failure was quite likely.

#### Ineffective Charter Act Restrictions and Supervision of Safety and Soundness

Although policymakers could not use the federal budget process to control the cost of the implicit federal guarantee of the NIC's obligations and the incentives created by that guarantee, they could exert indirect, nonbudgetary control over the corporation. That control would include charter act restrictions on its legal authority to take risks and the designation of an existing or the establishment of a new federal agency to supervise the corporation's safety and soundness. Both of those indirect approaches to controlling the government's costs would have significant shortcomings.<sup>7</sup>

There would be a tension between using charter act restrictions to limit the NIC's ability to take risks and providing subsidies to infrastructure borrowers. For example, policymakers could limit the corporation to incurring the credit risk of bonds that were of investment-grade credit quality. The charters of the two largest GSEs, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), include such provisions. But that restriction would prevent the NIC from financing some infrastructure projects that the commission believed should receive new federal subsidies.

Policymakers could also attempt to control indirectly the risk posed by the NIC by requiring it to comply with federal capital requirements and by

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6. Technically, the incentive would be greatest if the NIC was insolvent on a marked-to-market basis (that is, the market value of its assets was less than the market value of its liabilities) and the economic value of the corporation's expected future business was low or negative.

7. For a general discussion of these issues, see Congressional Budget Office, *Controlling the Risks of Government-Sponsored Enterprises* (April 1991), Chapter 2.



directing a federal supervisory agency to force the corporation to sell additional stock if it suffered losses that eroded its capital. Standards could be set in the corporation's charter, or they could be established by a supervisory agency. Capital requirements, however, probably would not limit the government's exposure to risk very effectively, at least in the short run, for two reasons.

First, some of the infrastructure debt that the NIC would finance might not be currently sold in the municipal credit markets and, in many cases, would be of below-investment-grade quality. It would be difficult for policymakers to write into law capital requirements or recapitalization rules that were not largely arbitrary. On one hand, the standards might be too stringent and could hamper the NIC's ability to do business.<sup>8</sup> On the other hand, they might be too lenient, in which case a supervisory agency would need clear statutory authority to impose tougher ones. The absence of information on the credit risk of the bonds that the corporation would buy would make the same tasks difficult for the supervisory agency.

Second, it is not clear that the commission or potential proponents of organizing the NIC as a government-sponsored enterprise would be committed to giving a supervisory agency the statutory authority and political support that it would need to closely monitor the corporation's risk taking in the early years of its operations, when defaults on the infrastructure bonds that it purchased would be fewer than in the long run. On the contrary, the agency would probably be under considerable pressure to allow the corporation to provide a large volume of deeply subsidized loans and guarantees in order to produce an increase in the overall volume of infrastructure investment.

### Relatively High Level of Federal Exposure to Risk

Establishing the NIC as a government-sponsored enterprise would also expose the federal government to a relatively high level of risk. In the first place, because neither the federal government nor the private sector now finances the riskiest infrastructure bonds that the corporation would finance, there would be considerable uncertainty about how successful the NIC would be. In contrast, when the government established the two GSEs that subsidize the secondary mortgage market--Fannie Mae and Freddie Mac--more than 20 years ago, there

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8. This problem has plagued the Federal Agricultural Mortgage Corporation (Farmer Mac), a GSE established in 1987 to bear the credit risk on securities backed by pools of agricultural mortgage loans. Wary of Farmer Mac's incurring too much credit risk in the volatile agricultural sector, the Congress required that securities guaranteed by the GSE be protected by liquid, low-risk funds or subordinated debt equal to 10 percent of the loans in each pool. That requirement has protected the government but has hampered Farmer Mac's ability to make its guarantee services attractive to lenders who make agricultural mortgage loans.

was little uncertainty about the profitability of their basic lines of business. When Fannie Mae became a GSE in 1968, an on-budget federal agency--the Federal Housing Administration (FHA)--had already demonstrated that long-term, fixed-rate home mortgages could be underwritten to national standards and profitably insured. When the Congress created Freddie Mac and authorized both it and Fannie Mae to securitize home mortgages in 1971, another on-budget agency--the Government National Mortgage Association (Ginnie Mae)--had already shown that securitization of such loans was feasible.

In the second place, even if the NIC was able to develop into a profitable firm, it would probably pose a relatively high level of risk to the federal government. Chapter I concluded that all of the subordinated infrastructure debt that the corporation purchased would be eligible for below-investment-grade credit ratings. That conclusion implies that, unless the NIC purchased a much higher volume of investment-grade senior bonds than is implied by the commission's report, the corporation's overall exposure to risk would be relatively high--comparable to that of a firm with a credit rating of double B (the highest below-investment-grade rating) or perhaps a weak triple-B rating. In 1991, Standard & Poor's Corporation (S&P), a private credit rating agency, found that at the end of 1990, the Farm Credit System (FCS) was comparable to a firm with a credit rating of double B.<sup>9</sup> The risk that the FCS poses to the government has declined in the past several years, but it remains the riskiest of the existing GSEs.

#### ESTABLISHING THE NIC AS A SPECIAL-PURPOSE FINANCE COMPANY

The NIC could also be organized as an off-budget, special-purpose finance company that would be chartered to provide credit assistance to municipal infrastructure borrowers. To subsidize the corporation's activities, the government would neither make federal grants nor give it the legal characteristics of a GSE that would imply a federal guarantee of its debt securities. Instead, the government would make a long-term, subordinated loan

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9. Credit ratings can be used as summary indicators of the government's relative exposure to the risk of the several enterprises. The ratings provide rough ordinal measures of the relative probabilities that each GSE will become insolvent and unable to meet its obligations without borrowing on the strength of its implicit federal guarantee or receiving federal financial assistance. Issues about the use of credit ratings to assess the government's exposure to GSE risks are analyzed in Congressional Budget Office, *Controlling the Risks of Government-Sponsored Enterprises*, pp. 50-55; and General Accounting Office, *Government-Sponsored Enterprises: Using Private Risk Ratings for Exemptions from Federal Regulations* (November 1991). S&P's report is contained in Department of the Treasury, *Report of the Secretary of the Treasury on Government-Sponsored Enterprises* (April 1991), Appendix.

to the NIC at a below-market interest rate. The loan would subsidize the corporation's operations and give it time to demonstrate to the private sector that it was profitable and creditworthy enough to attract private investors.

### The Precedent of the National Consumer Cooperative Bank

The precedent for this organizational form is the National Consumer Cooperative Bank. The bank is a federally chartered, cooperatively owned financial institution; operating as the National Cooperative Bank (NCB), it provides loans and financial services to cooperatives.<sup>10</sup> The NCB was established as a federal agency in 1978 and was converted to private, cooperative ownership at the end of 1981. The legislation that privatized the bank required the Treasury to make a 39-year loan of \$184.3 million that extinguished an equal amount of preferred stock owned by the government. Through fiscal year 1990, federal law limited the interest rate on the loan to no more than 25 percent of the NCB's gross revenues less necessary operating expenses, including a provision for possible credit losses. For the remaining life of the loan, a statutory formula sets the rate on the basis of a weighted average of the yields on Treasury securities of several maturities. The loan is subordinated to all other liabilities of the NCB. Because the loan paid very low interest rates initially and posed substantial credit risk to the government, it had a subsidy cost of at least 60 percent of the principal amount.<sup>11</sup>

The terms of the federal government's subordinated loan to the NCB divide its life as a private corporation into three periods. In the first period, from 1982 through late 1990, the bank's interest costs were quite low, reflecting the below-market rate on the Treasury loan. The subsidies provided by the loan gave the NCB time to build a capital base and develop expertise in lending to cooperatives. The second period began when the interest rate on the Treasury loan changed at the end of fiscal year 1990. Since that time, the bank has demonstrated that it is profitable enough to pay higher interest costs and has convinced the private sector that it is a creditworthy issuer of senior debt. At present, the bank has a line of credit with a group of commercial banks. Three credit rating agencies have given its short-term senior debt an investment-grade rating. Each rating assumes that the government would not protect the NCB's creditors if the bank got into financial trouble. The third period of the NCB's

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10. For information on the bank's recent financial performance, see National Cooperative Bank, *1992 Annual Report* (Washington, D.C.: National Cooperative Bank, 1993).

11. That estimate assumes that the loan was to pay a 2 percent interest rate through 1990 and 10 percent thereafter, and that the credit risk of the loan was equivalent to that of a corporate bond with a credit rating of double B, the highest below-investment-grade rating.

life will begin after the government's loan is due in 2020. At that point, the bank either will have demonstrated that it can be profitable enough without federal subsidies to attract private equity and credit, or it will have to go out of business. The NCB plans to prepare for the transition to unsubsidized operations by developing a strategy for retiring the subordinated federal loan.

#### Comparison with Other Approaches to Organizing the NIC

If the NIC was organized as a finance company and subsidized with a federal loan, the subsidy cost of the loan would be recorded in the federal budget and controlled through the appropriation process. Because the company would lack the legal attributes that characterize the GSEs and because investors would know that policymakers intended it to stand on its own after it repaid the government's loan, it probably would not benefit from an implicit federal guarantee of its obligations. Consequently, the company would be subject to greater market discipline than a GSE and would have a strong incentive to use most of the limited, one-time subsidy it received to build its capital and establish a track record that would enable it to attract private investors. In contrast, a GSE, which would receive ongoing subsidies, could--and would have an incentive to--pass a portion of them to infrastructure borrowers in the form of below-market prices for its services.

#### ESTABLISHING THE IIC AS A MUNICIPAL BOND INSURER

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The commission proposed that the IIC be organized as a private, for-profit municipal bond insurer. The infrastructure bonds that it could insure would be restricted: they would have to be eligible for an investment-grade credit rating of no higher than triple B, and other firms in the bond insurance industry would have to have declined to insure them. The commission intended that the IIC would maintain a triple-A credit rating on the strength of its underwriting, management, investment policy, capital, and premium income.

Private ownership would allow the IIC to insure tax-exempt infrastructure bonds and give it an incentive to charge premiums that enabled it to earn a market rate of return on equity. The cost to the government of providing part of the IIC's capital would be recorded in the federal budget. Policymakers would have to require the firm to raise the majority of its capital from private investors to ensure that the Internal Revenue Service exempted infrastructure bonds insured by the company from federal taxation. Policymakers might also want to set a sunset date for the IIC.

### The Necessity and Advantages of Majority Private Ownership

In order for the IIC to operate as a private, for-profit firm, the company would have to raise the majority of its initial capital from private investors rather than from the federal government. The IIC would also have to raise any additional capital that it needed in the future from private investors. If either of those conditions was not met, it would be difficult for the IRS to justify allowing the interest on bonds that the company insured to escape federal taxation. Initial majority ownership of the firm by the government, whether through an on-budget agency or an off-budget revolving fund, would suggest that policymakers stood ready to provide additional funds if the firm ever suffered large losses and was unable to pay claims by insured bondholders. Subsequent federal stock purchases would have the same implication. Current law requires the IRS to deny tax-exempt status to any municipal debt that carries a federal guarantee. If the NIC was organized as a GSE, it would probably qualify as a private owner of the IIC.

The most important implication of requiring the private sector to provide the majority of the IIC's initial and all of its future capital is that, under current policy, the company would be able to insure tax-exempt infrastructure debt. Another effect of strictly limiting the government's investment is that the firm would have to earn a market rate of return on its capital to attract private investors. The requirement of adequate profitability would have several implications:

- o It would give the IIC an incentive to develop prudent underwriting standards and investment policies and to charge adequate insurance premiums. As a result of those incentives, the company might be better managed than a federal agency and more likely to profitably insure infrastructure bonds that other municipal bond insurers do not now insure.
- o The IIC would have an incentive to avoid insuring the riskiest infrastructure bonds.
- o The company would not be able to charge subsidized insurance premiums without dissipating its capital, losing its triple-A credit rating, and being unable to write new insurance. Unlike a federal agency that insured taxable municipal bonds, the company's premiums would have to be high enough to pay its administrative expenses and earn adequate profits.

Uncertainty About the IIC's Profitability  
and Ability to Obtain a Triple-A Credit Rating

The IIC might not be profitable enough to attract private capital and be self-supporting, and it might not be able to obtain a triple-A credit rating. The federal government's restrictions would tend to limit the company to insuring infrastructure bonds issued in small amounts by the least creditworthy municipalities. If, as the commission assumed, many of the issues would be of below-investment-grade caliber, the company would be exposed to significantly greater credit risk than other municipal bond insurers, which would make it difficult to obtain a triple-A rating. Many of the borrowers that the IIC served would not have issued debt publicly or obtained bond insurance in the past; as a result, there would be uncertainty about the credit risk of their bonds and about the premiums that the IIC would have to charge for bearing that risk.

The company would be especially vulnerable to mistakes in underwriting and investment of premium income in the short run. Investors would not be willing to pay as much for bonds that the IIC insured initially as they would for those it insured later on, provided that it was successful in the business, had insured a large portfolio of bonds, and was rated triple A by several rating agencies. The lower sales prices would mean higher interest rates for issuers. The company would have to make up for the higher interest rates by charging lower insurance premiums than it could charge in the long run if it was successful. The lower premiums would leave a smaller margin for errors in the firm's underwriting and investment policies.

Potential Risks of Minority Federal Ownership

Some observers argue that minority federal ownership of the IIC would give the company a competitive advantage over other bond insurers. They claim that investors in infrastructure bonds insured by the IIC would have good reason to believe that the government stood ready to prevent the company from defaulting on any of its insurance. If the belief in the existence of an implicit federal guarantee was widespread, the yields on bonds insured by the IIC would be lower than those on bonds insured by other firms in the industry. That outcome would make the IIC's insurance more attractive to borrowers, who would be willing to pay higher premiums for it, and would give the company a competitive advantage.

There are reasons to believe that investors would not perceive an implicit federal guarantee of bonds insured by the IIC, at least not in the short run. If the company suffered losses that caused it to lose its triple-A rating, the firm

would have an incentive to turn to the private sector, rather than to the government, to raise additional capital. That incentive would exist because an infusion of federal funds could lead the IRS to revoke the tax-exempt status of the bonds that the IIC had insured, which would harm the company's economic value. Furthermore, policymakers would be unlikely to provide assistance when the firm was still solvent.

Of course, if the IIC incurred losses that completely eroded its capital, policymakers could always choose to appropriate funds to the company to protect investors in the bonds that it had insured. If the firm was successful enough to insure a large volume of bonds, investors in those bonds might believe that policymakers would be increasingly unlikely to allow them to incur losses. It is not clear, however, that the IIC would benefit very much from such a perception, because investors would also tend to believe that the company would have every incentive to maintain its triple-A rating. Policymakers could limit the risk that the potential for an implicit federal guarantee posed to the government by capping the dollar volume of infrastructure bonds that the IIC could insure. A cap might also make policymakers less inclined to bail out the firm if it ever got into trouble.

#### Setting a Sunset Date

Policymakers may want to use the IIC to provide only temporary federal support for innovation in the insurance of infrastructure debt. That goal could be accomplished by setting a date after which the company would be allowed to insure any type of municipal bonds. If the NIC or the federal government owned stock in the IIC, the shares would have to be sold at that time.

#### The Experience of Connie Lee

The commission asserted that the experience of the College Construction Loan Insurance Association (Connie Lee) indicates that the IIC would be profitable enough to attract private capital and be self-supporting. Yet several factors make the relevance of that experience questionable. If the IIC insured some non-investment-grade bonds, it would be exposed to more credit risk than Connie Lee. In addition, although Connie Lee has been profitable and maintained a triple-A rating, it has only been in business for five years and has been functioning as a primary insurer for just over two; it is thus too early to reach a definitive conclusion about its long-run prospects. The company's earnings during this initial period have been lower than they are likely to be once it has written a large volume of insurance and its operating expenses are

a smaller and more stable proportion of its premium and investment income. (It is common for start-up financial guaranty companies to increase their earnings gradually as their insured volume grows.)

Another significant factor is that federal law restricts Connie Lee to insuring bonds issued to finance higher education facilities and teaching hospitals, which pose a greater credit risk than many other types of municipal bonds. The restriction prevents the company from diversifying its exposure across the different sectors of the market and, in the long run, will prevent it from insuring as large a volume of municipal bonds as another triple-A-rated but better diversified firm could insure with the same amount of capital.<sup>12</sup> The smaller volume of business that Connie Lee's capital can support will limit the company's income from premiums and investments. The firm will try to make up for the smaller volume by charging higher premiums, but there is no guarantee that this strategy will succeed, because Connie Lee will face competition from other bond insurers and from investors who are willing to buy uninsured debt.

If Connie Lee earned a below-market rate of return on equity in the long run, the company could have difficulty raising the capital necessary to continue writing insurance indefinitely. Connie Lee argues that it will be able to charge high enough premiums to maintain its triple-A rating, earn a market rate of return, and continue to write insurance indefinitely.<sup>13</sup> The Department of Education could conduct a market test of that view by selling its stock in the company, as allowed by current law, when the firm has completed the start-up phase of its operations. The alternative is to wait and see how Connie Lee performs over time.

## SUMMING UP THE OPTIONS

The objectives that policymakers sought to achieve by establishing the NIC and the IIC would influence the way in which they chose to organize the corporations. Organizing the NIC as on-budget agency would be appropriate if the objectives were the following: to convey relatively large, ongoing subsidies to finance infrastructure projects that the private sector probably could not

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12. Connie Lee could do a larger volume of business by reinsuring higher education and teaching hospital bonds, which it may reinsure regardless of their credit ratings. But the other insurers in the market have refused to allow Connie Lee to reinsure bonds that they have insured except on a case-by-case basis.

13. An analyst at one credit rating agency has estimated that the federal government's \$19 million investment in Connie Lee has a current market value of only \$7 million. Connie Lee asserts that the stock has actually appreciated in value. See Paul Starobin, "Connie's Prizefight," *National Journal*, June 26, 1993, pp. 1642-1645.



finance without federal help; to provide fairly accurate, comprehensive, and timely information about the cost of the subsidies; and to give policymakers direct control over that cost and the corporation's activities. Making the NIC a government-sponsored enterprise would be appropriate if policymakers wanted to provide smaller, ongoing subsidies--but wanted as well to keep the subsidies from being recorded in the budget or controlled through the budget process. Organizing the NIC as a private finance company would be appropriate if policymakers had a twofold aim: on one hand, to provide and record in the budget a one-time federal subsidy to induce a private firm to bear the risks of developing and financing infrastructure projects that would not be undertaken otherwise, but on the other hand, to keep from providing permanent subsidies to a new financial institution that would compete with existing private firms.

Organizing the IIC as an on-budget agency would be appropriate if policymakers wanted the company to insure some below-investment-grade infrastructure bonds but did not want to risk the IIC's not being profitable enough to survive as a private firm. The on-budget status would also allow policymakers to exert direct control over the company's activities. Making the IIC a private, for-profit firm would be appropriate if policymakers wanted the company to be able to insure tax-exempt bonds but at the same time wanted to minimize any competitive advantage that the firm had over other bond insurers. It would also be appropriate if policymakers did not wish the IIC to focus on insuring below-investment-grade issues.

